DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE LEGAL ADVICE

MEMORANDUM FOR
ASSOCIATE AREA COUNSEL
CC:SB/SE

FROM: Heather C. Maloy
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(Income Tax & Accounting)

SUBJECT: Applicability of § 104(a)(2)

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This memorandum responds to your December 31, 2001, request for field service advice concerning §§ 61, 104(a)(2) and 1001 of the Internal Revenue Code. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

A =
B =
Date D =
Date E =
Date F =
Year 1 =
$X =

ISSUES

1. Whether amounts received by A pursuant to a defamation settlement agreement between A and B were payments in connection with a disposition of property and thus subject to the gain or loss provisions of § 1001 of the Internal Revenue Code.

2. Whether the 1996 amendment to § 104(a)(2) has retroactive application to A and, if so, whether the amendment is an unconstitutional violation of the Due Process Clause.

CONCLUSIONS

1. The amounts A received pursuant to the defamation settlement agreement with B are not payments in connection with a disposition of property and thus not subject to the gain or loss provisions of § 1001.

2. The 1996 amendment to §104(a)(2) rationally relates to a legitimate legislative purpose and thus its retroactive application, if any, is not an unconstitutional violation of the Due Process Clause.

FACTS

A worked for B from Year 1 through Date D. B terminated A's employment on Date D for allegedly inappropriate behavior. A alleged that such termination was without cause and constituted wrongful termination. In the days immediately following A's termination, employees of B made several allegedly false and defamatory statements about A. These statements were reproduced in trade publications and on several television and radio stations.

A alleged that he suffered damages as a result of his wrongful termination and personal injuries from the defamatory statements. On Date E, A and B reached an oral agreement and soon thereafter executed two settlement agreements. The separate agreements were an employment termination agreement and a defamation agreement. The agreements were executed in Date F (after September 13, 1995). It is our understanding that A never filed a lawsuit against B. The defamation agreement required B to pay A: (1) two payments of $X in (one before and one after August 20,), (2) $X in , and (3) $X in . In exchange for the payments, A agreed to release B from all claims.

A is a cash-basis taxpayer. A excluded the first payment from income on his tax return. A reported the second payment made after August 20, , on his return, but later filed an amended return for claiming a refund for the taxes attributable to the post-August 20, payment. A did not include the third or fourth payments in his gross income on his tax returns for and .

Solely for purposes of this request, we assume that A was wrongfully terminated and defamed by B and that A suffered personal injuries and damages as a result. For purposes of this request, we also assume that the payments made to A pursuant to the Defamation Agreement had an ascertainable fair market value on Date F, when A and B entered into the settlement agreement.

LAW AND ANALYSIS

Section 61 of the Internal Revenue Code defines gross income as all income from whatever source derived, except as specifically excluded by other provisions of the Code. Thus, under § 61, an accession to wealth is presumed to be gross income unless the taxpayer can demonstrate that the accession fits into one of the specific exclusions created by other sections of the Code. Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955).

Section 104(a)(2) excludes from gross income the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or periodic payments) on account of personal physical injuries or physical sickness.

Prior to its amendment by the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605, 110 Stat. 1755 (1996), §104(a)(2) generally excluded from gross income damages received (whether by suit or agreement) for personal injury or illness. Section 104(a)(2) included no requirement that the damage payments be on account of physical injuries. Thus, under prior law, some taxpayers were permitted to exclude from gross income damages received on account of a non-physical injury.

The Small Business Job Protection Act restricted the application of § 104(a)(2) to damages received on account of a personal physical injury or illness. The amendment to § 104(a)(2) generally applies to any amounts received after August 20, 1996. However, if such amount is received pursuant to a written binding agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995, the post-August 20, 1996 payments are subject to § 104(a)(2) as in effect prior to its amendment.

In the present case, there was no written binding agreement, court decree, or mediation award in effect on, or issued on or before, September 13, 1995. Consequently, any payments received after August 20, 1996, are subject to amended § 104(a)(2), which does not apply to non-physical injuries such as defamation damages. It is A's contention, however, that the payments from B should be viewed as payments received in connection with a disposition of property and, therefore, should be governed by the gain or loss provisions of § 1001. Accordingly, A contends that, because the deferred payment obligation given to A by B had an ascertainable fair market value on Date F, the and payments should be treated as realized on Date F based on the principles explained in Warren Jones v. Commissioner, 524 F.2d 788 (9th Cir. 1975), rev'g 60 T.C. 663 (1973). A therefore argues that, because Date F is prior to August 20, 1996, the and payments are excluded from gross income under old § 104(a)(2).

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized therefrom over the adjusted basis. Under § 1001(b), the amount realized in a sale or exchange includes the fair market value of any property received.

In Warren Jones, supra, the taxpayer sold an apartment building in exchange for a cash down payment and a contractual obligation to make monthly payments over 15 years. On appeal, the 9th Circuit determined that the issue to be decided was whether § 1001(b) required the taxpayer to include as an amount realized the fair market value of its real estate contract with the buyer in the taxable year of the sale. The court concluded that the real estate contract had an ascertainable fair market value and that the taxpayer had to include that fair market value in the taxpayer's amount realized under §1001(b). "...[I]f the fair market value of property received in exchange can be ascertained, that fair market value must be reported as an amount realized." Id. at 792.

We agree with A that, for purposes of determining gain or loss under § 1001, amount realized must include the fair market value of deferred payment obligations received in a sale or exchange. However, for the reasons set forth in Alexander v. Commissioner, T.C. Memo 1995-51, aff'd, 72 F.3d 938 (1st Cir. 1995), the execution of a settlement agreement does not constitute a disposition of property. Accordingly, we do not believe A's receipt of payments pursuant to the deferred payment obligation executed with B is governed by § 1001.

In Alexander, supra, the Tax Court examined the manner in which legal fees incurred by a taxpayer in connection with a settlement of a wrongful termination suit should be treated. The taxpayer argued that the settlement was a disposition of intangible assets (the relinquishment of claims relating to an employment contract and retirement benefits) governed by § 1001, and the legal fees were part of the cost incurred in the disposition of the assets. Thus, the taxpayer argued that he properly deducted the legal fees from the amount realized from the settlement, pursuant to § 1001, to determine the amount of gain from the disposition of the settlement claims.

The Tax Court, however, rejected the taxpayer's § 1001 argument stating that, in substance, the taxpayer was suing for damages he suffered by the loss of his employment, not disposing of assets. The taxpayer's damages were the loss of compensation in terms of salary and retirement benefits and such compensation would have constituted ordinary income to the taxpayer. Consequently, the taxpayer's contention that the relinquishment of his contractual claims was a disposition of intangible assets failed because the taxpayer essentially received settlement proceeds in lieu of compensation.

The Tax Court also disagreed with the taxpayer's argument that a settlement of a legal claim constitutes a disposition of property based on Herbert's Estate v. Commissioner, 139 F.2d 756 (3d Cir. 1943). In that case, Herbert held a claim against a corporation, which claim was represented by notes and an open account, at the date of his death. Herbert's estate collected on the claim and received an amount greater than the value of the claim at the date of Herbert's death. The dispute concerned the legal effect to the estate of the payments it received from the debtor. The Court of Appeals for the Third Circuit held that the payment of the claim was a disposition of such claim and, therefore, the estate had income only to the extent the amount it received exceeded the stipulated value of the claim at the date of Herbert's death. Id.

The taxpayer in Alexander argued that his case should be controlled by the decision in Herbert's Estate and thus his settlement proceeds should be treated as gain or loss on disposition. The Tax Court in Alexander, however, determined that Herbert's Estate was inapplicable because, unlike the estate, the taxpayer in Alexander did not hold a claim against his former employer in the sense of a debt. In Herbert's Estate, the decedent was characterized as a creditor, whereas in Alexander, the taxpayer was not a creditor of his former employer. Thus, unlike the taxpayer in Herbert's Estate, the taxpayer in Alexander did not receive payments in disposition of an existing indebtedness.

Similarly, in the present case, A's execution of a settlement agreement with B does not constitute a disposition of property by A. Accordingly, while we would concede that the deferred payment obligation had a fair market value when received by A, § 1001(b) does not apply to A's situation because there was no disposition of property.

Finally, it should be noted that even if § 1001 applied to the deferred payments received by A, § 453 would preclude the recognition of the and payments in , unless A elected out of the installment method under § 453(d). Section 453(a) provides that income from an installment sale shall be taken into account under the installment method. Under § 453(b), an installment sale is defined as a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs.

Section 453(c) defines installment method as a method under which the income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when the payment is completed) bears to the total contract price.

In the present case, if as A contends his execution of a settlement agreement with B constitutes a disposition of property by A, the payments would be treated as an installment sale because A received two of the four payments after the close of the taxable year in which the disposition occurred ( ). Consequently, unless A elected out of the installment method, the stream of payments would be taxable under the installment method.

Constitutional Issue

The taxpayer has also questioned the constitutionality of § 104(a)(2) as amended by the Small Business Job Protection Act of 1996. As discussed above, §104(a)(2) was amended on August 20, 1996, to limit its application to physical personal injuries and physical sickness. The amendment to § 104(a)(2) generally applies to amounts received after August 20, 1996. However, any amount received pursuant to a written binding agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995, is subject to § 104(a)(2) as in effect prior to its amendment. The taxpayer has set forth the argument that, because § 104(a)(2) was amended on August 20, 1996, but Congress used September 13, 1995, in determining whether a taxpayer had a pre-existing binding agreement not subject to the new provision, the legislation is retroactive and violates the Due Process Clause.

First, we question whether the legislation is, in fact, retroactive. Granted, the legislation includes a binding agreement date that is prior to the effective date of the legislation. However, the amendment to § 104(a)(2) does not apply prior to the date the legislation was enacted, August 20, 1996. That is, irrespective of the date on which any agreement to pay personal injury damages was entered into, the amended version of § 104(a)(2) applies only to payments received after August 20, 1996.

In the present case, the event triggering A's tax liability is not the absence of an agreement entered into before September 13, 1995, but the receipt of payments by A after August 20, 1996. Even though the agreement between A and B was entered into after September 13, 1995, the payments received pursuant to the agreement would still have been subject to old § 104(a)(2) had the payments been received on or before August 20, 1996. Thus, the primary event on which the legislation focuses is the date on which the payments are received. Applying amended § 104(a)(2) only to payments made after August 20, 1996, the date on which the legislation was enacted, should not be treated as a retroactive application of the provision.

Further, even if the amended version of § 104(a)(2) is found to apply retroactively, Congress' use of the September 13, 1995, date should not be considered a violation the Due Process clause. Tax legislation has regularly been upheld even though it contains elements of retroactivity. United States. v. Carlton, 512 U.S. 26

(1994); United States v. Darusmont, 449 U.S. 292 (1981); Welch v. Henry, 305 U.S. 134 (1938). The courts have held that only where the retroactive application is "so harsh and oppressive as to transgress the constitutional limitation," Welch v. Henry, 305 U.S. at 147, may such a statute be found to violate due process. "The due process standard to be applied to tax statutes with retroactive effect, therefore, is the same as that generally applicable to retroactive economic legislation: Provided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches . . . " (Citations omitted). United States. v. Carlton, supra at 28 (1994).

The Supreme Court in United States v. Darusmont, supra at 296-297, noted that retroactive effective dates are very common with tax legislation. Congress "almost without exception" has given general revenue statutes effective dates prior to the dates of actual enactment. This "customary congressional practice" generally has been "confined to short and limited periods required by the practicalities of producing national legislation."

In the present case, Congress' use of September 13, 1995, in determining whether a taxpayer had entered into a binding agreement relating to personal injury damages was neither illegitimate nor arbitrary. Rather, the choice of September 13, 1995, was reasonable, related to a legitimate governmental purpose, and required by the practicalities of producing legislation. Congress originally proposed amending § 104(a)(2) in the Balanced Budget Act of 1995, H.R. 2491, 104th Cong. § 13611 (1995). The amendment to § 104(a)(2) in the Balanced Budget Act of 1995 used almost identical effective date language as that set forth in the Small Business Job Protection Act in 1996.[1] When drafting the provisions of the Balanced Budget Act of 1995, the House Committee on Ways and Means held a markup session on certain tax reforms, including the amendment to § 104(a)(2), on September 18, 1995. In the description of the Chairman's markup, the Joint Committee on Taxation chose September 13, 1995, as the effective date for amounts received under a written binding agreement, court decree, or mediation award. Thus, September 13, 1995, relates back to an earlier piece of legislation, the Balanced Budget Act of 1995.

Legislative bills retain their status from session to session of the same Congress. See Miles Oscar Price, Harry Bitner & Shirley Raissi Bysiewicz, Effective Legal Research, 45 (1979). The 104th Congress was in power for two different sessions during 1995 and 1996. In such situations, it is long-standing standard procedure

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[1] The only language difference relates to the "amounts received after" date. In the Small Business Job Protection Act of 1995, the date used was December 31, 1995, while August 20, 1996, was the date used in Small Business Job Protection Act of 1996. Otherwise, the language is identical.

for Congress to keep the same language of a previous bill from a prior session. To do otherwise and start over with new language from session to session would be onerous and inefficient. As such, choosing to use the same language from a previous bill clearly serves a legitimate governmental purpose.

As to why the September 13, 1995, date was originally chosen, it is common practice for Congress to choose the announcement date for a markup session as a cut-off for things such as binding agreements. Congress frequently announces the bill scheduled for the Chairman's markup three business days prior to the scheduled markup session. In 1995, September 13th, a Wednesday, was three business days prior to the scheduled markup date, September 18th.

Further, while A will likely argue that he relied to his detriment on old § 104(a)(2) when entering into the agreement with B, it is well settled that reliance alone is insufficient to establish a constitutional violation. Rather, a court must consider the nature of the tax and the circumstances of its application to determine whether retroactive application is so harsh and oppressive that it violates due process. In this respect, retroactive application has been held unconstitutional only in situations in which a statute imposed a wholly new tax that could not reasonably have been anticipated by the taxpayer at the time of the transaction. United States. v. Carlton, supra; Welch v. Henry, supra; Wiggins v. Commissioner, 904 F.2d 311 (5th Cir. 1990).

In the present case, the amended version of § 104(a)(2) is not a “wholly new tax” for A. First, exclusions from gross income are a matter of legislative grace and exist solely by virtue of specific legislation. See New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934). Limiting the application of an exclusion from gross income should not be considered a wholly new tax. Further, it seems illogical to call the amendment to § 104(a)(2) a new tax since it’s quite possible that the payments received by A would not have been excluded from A’s income under old § 104(a)(2) anyway. Prior to the 1996 amendment to § 104(a)(2), the treatment of non-physical injuries under § 104(a)(2) was simply not clear and was the subject of much litigation. One of the reasons for the amendment to § 104(a)(2) was to provide certainty to taxpayers. Thus, with respect to the payments A received before the August 20, 1996, amendment to § 104(a)(2), clearly there was no certainty as to the application of § 104(a)(2), which further dispels the notion that the 1996 amendment was a new tax to A.

Finally, the amended version of § 104(a)(2) and its potential impact on A could reasonably have been anticipated by A when the agreement with B was entered into. As discussed above, Congress originally proposed amending § 104(a)(2) in the Balanced Budget Act of 1995, which was well before the date on which A’s agreement with B was entered into. Moreover, the September 13, 1995, binding agreement date was actually used in the Balanced Budget Act of 1995 legislation.

A, therefore, is simply not in a position to claim surprise at the new legislation and the use of the September 13, 1995, binding agreement date.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

Although a cash equivalent does not require a formal note, the contract rights must be of a type commonly sold or given as part of the purchase price, See Estate of Ennis v. Commissoner, 23 T.C. 799 (1955); Ennis v. Commissioner, 17 T.C. 465 1951); Johnston v. Commissioner, 14 T.C. 560 (1950).

[redacted]

Please call (202) 622-4920 if you have any further questions.